Q1 2020

UK Private Company Director

Welcome to the April 2020 issue of UK Private Company Director, the quarterly newsletter for directors of owner-managed, family and private equity backed businesses.

We cover financial, legal, tax, wealth management and similar issues crucial to both building and realising the value of your business. Corbett Keeling's report on deal activity in the private equity markets also provides a clear insight into financial investor appetite.

The current issue highlights some of the impacts of COVID-19 and outlines several potential solutions:

- Although private company deal making started the year strongly, the lockdown will have a major impact on activity, but there are still buyers and funders in the market looking for opportunities to invest (pages 2 to 4).
- As private equity funds adapt their approaches in the current environment, we look into various strategies to cope with pricing issues and get greater deal certainty (page 5).
- After an exceptionally volatile first quarter for financial markets, we assess the outlook and consider ways to position investment portfolios (page 6).

Best wishes,

Megan Peel

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Corbett Keeling Corporate Finance

Dechert LLP

Kleinwort Hambros Societe Generale Group

Corbett Keeling
Corporate Finance

The way ahead

In the first quarter, transactions among UK private companies maintained the strong momentum from last year. But then came the COVID-19 lockdown, bringing many sections of the economy to an abrupt halt. Jim Keeling of corporate finance adviser Corbett Keeling analyses the data from the first quarter and ponders what may lie ahead.

These are difficult times. Quite apart from the misery and deaths caused by the coronavirus, the economic disruption has been immense. Only time will tell what the final impact will be on privately owned businesses in the UK. So much will depend on how long the restrictions on normal life and economic activity last. Even once they start to be eased, however, the return to normality will take many months.

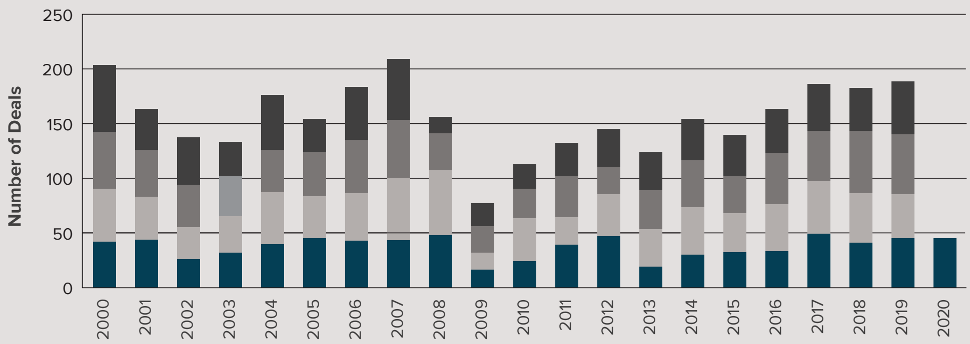
This will come as a cruel blow to many business owners and managers, particularly those who had been contemplating a sale or who now suddenly require short term funding to keep their operations afloat. However, liquidity remains available, and we know that many private equity firms and other potential buyers are still looking for interesting opportunities to invest among high quality businesses. And achieving a proper valuation is still possible, even where earnings have been temporarily reduced by the lockdown.

We have always had faith in the spirit of entrepreneurs, and today we see plenty of examples of business people rising to our altered circumstances and overcoming challenges through innovation and determination. Doubtless, new efficiencies and improved systems will be developed in response to the crisis. Even if it may seem barely possible now, many firms will survive and some will emerge stronger.

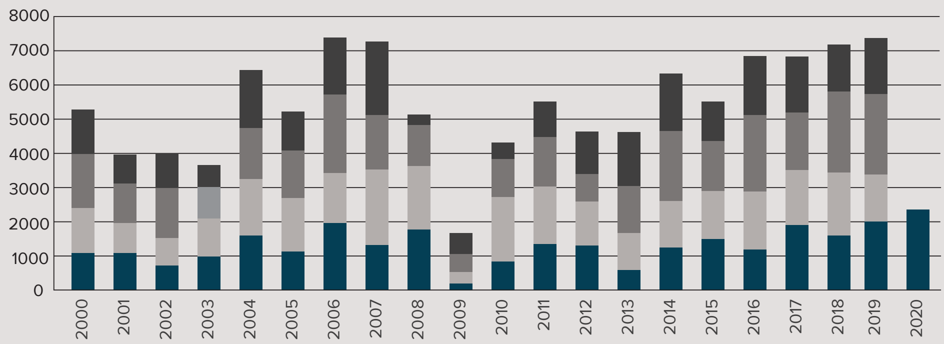
Assessing the deal data

Activity in the **smaller buy-outs** sector (transactions with enterprise value of less than £150 million) started the year well. The volume of deals was down only slightly, from 48 to 45, but their value increased, from an already strong £1.6 billion to £2.4 billion. That represents easily the best first quarter of any year since our data series began in 2000 – and, when the final figures are in, it may even have eclipsed the record for any one quarter.

Sub-£150m Buyouts by Volume



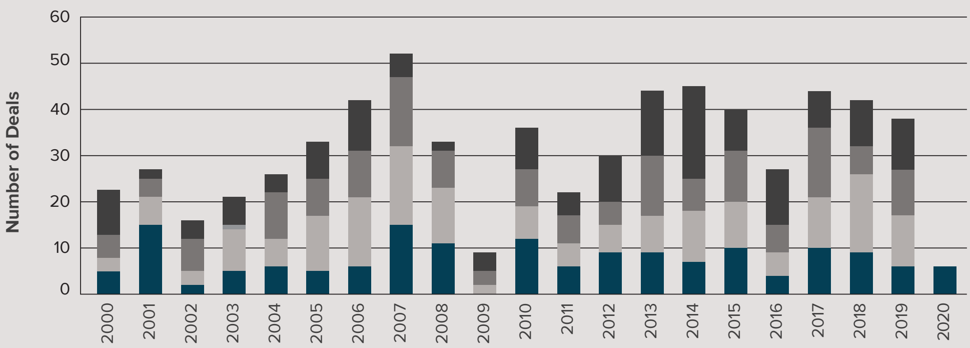
Sub-£150m Buyouts by Value



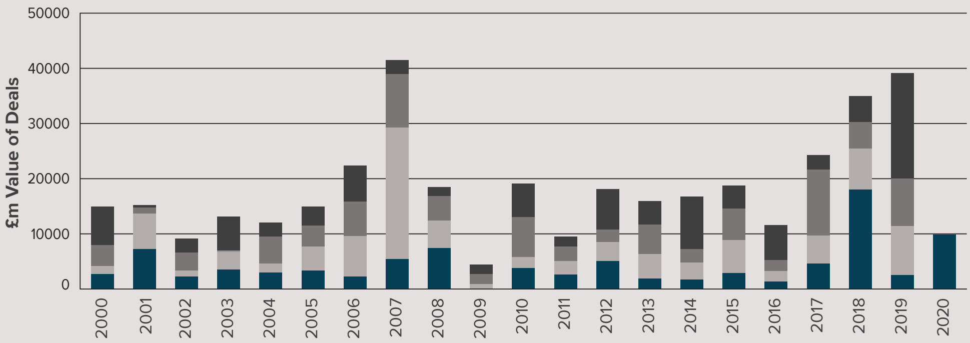
Key:
Q4
Q3
Q2
Q1

Not surprisingly, The **larger buy-outs** sector (enterprise value of £150 million or above) found it impossible to match the fourth quarter of 2019, when over £19.1 billion of deals were completed. Nevertheless, activity remained very solid, with six transactions at a total value of £9.8 billion, making it the second-strongest first quarter since our records began.

£150m+ Buyouts by Volume



£150m+ Buyouts by Value



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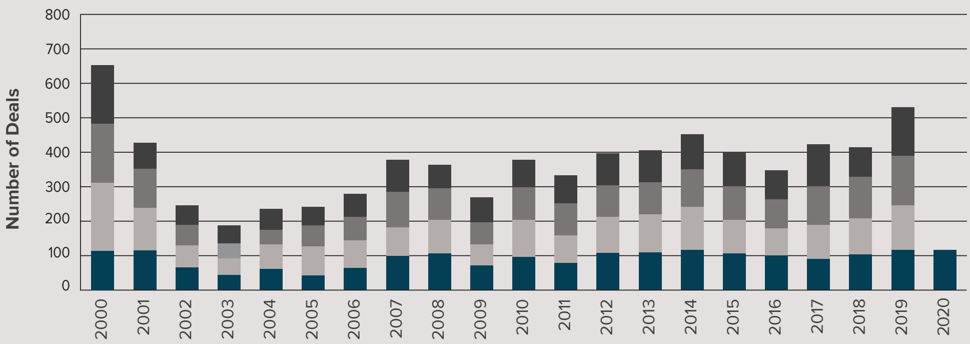
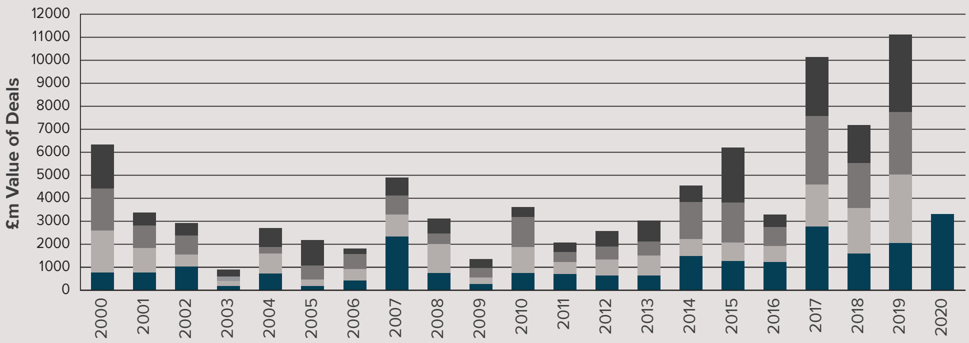
After a record year in 2019 for **early-stage and expansion capital deals,** the pace of activity remained strong in the first quarter. The number of transactions was down from 140 to a still respectable 116. Meanwhile, the value of deals held remarkably steady at just under last quarter's record £3.3 billion.

Volume of Early-Stage / Expansion Deals



Value of Early-Stage / Expansion Deals



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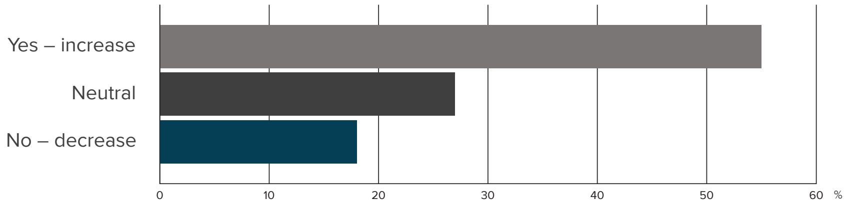
So what does our latest survey suggest?

Despite the sudden enforced slowdowns in many sections of the economy, the mood in the market remains pretty sanguine in the circumstances. Not surprisingly, the responses to our survey were decidedly less optimistic than last quarter, but they were still more positive than negative overall.

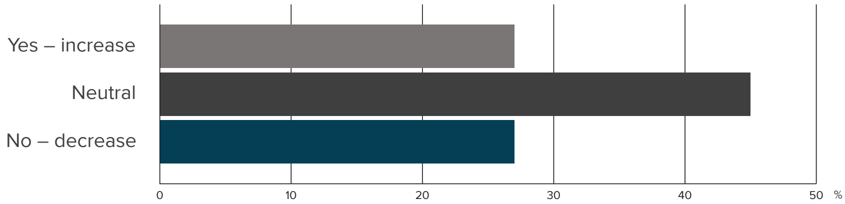
1 Do you expect deal volumes <£100m to increase or decrease?

For the smaller value segment of the market, the percentage of respondents predicting a rise in volumes over the next six months has fallen only slightly, from 71% to 55%. However, the proportion expecting a negative impact on activity has increased from zero to 18%.



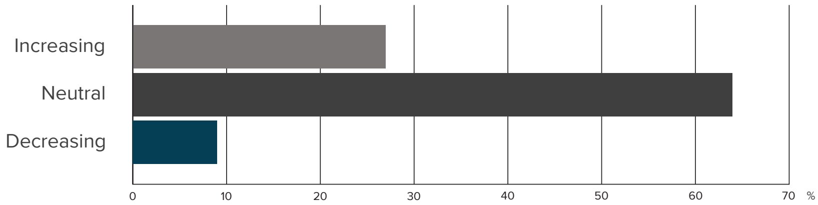
2 Do you expect deal volumes >£100m to increase or decrease?

For the larger value segment, sentiment is more evenly split. The percentage forecasting an increase in volumes dipped from 43% to 27%, on a par with those expecting a decrease. The remainder predict little change.



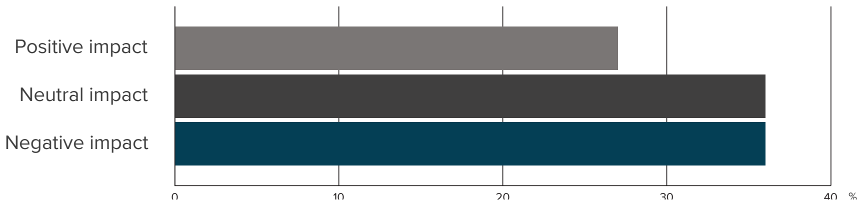
3 Is debt availability increasing, decreasing or neutral?

Given the latest easing of monetary policy from the Bank of England, it's perhaps little surprise that debt is expected to remain available, with just over a quarter of respondents looking for supply to increase further.



4 How have the restrictions imposed to stop the spread of Covid-19 affected your portfolio companies?

When asked how the restrictions related to COVID-19 have affected portfolio companies, 27% of our respondents said it had had a positive impact, while 36% said it had been negative. The rest reported a neutral impact.



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Dechert LLP

COVID-19
Impact on private equity transactions

In this new world of COVID-19, private equity funds are still hunting for deals. But their approach will be modified in order to deal with enhanced business risk and valuation challenges. Ivo Cavrak of Dechert LLP discusses specific due diligence and pricing issues, as well as some potential approaches which may be deployed while the pandemic lasts.

Due diligence issues

A legal due diligence exercise aims to identify actual or potential issues impacting the deal, as well as any solutions. It also seeks to confirm the fundamental assumptions underpinning the transaction. In light of COVID-19, buyers will need to consider material legal diligence issues including:

- **Commercial contracts** – reviewing the provisions which might have an impact on the certainty of revenues (such as termination, exclusivity, minimum purchase quantities).
- **Regulatory/support matters** – analysing any implemented or available governmental COVID-19 measures.
- **Financing** – understanding access to additional liquidity under the target's existing financing arrangements and any potential breach of borrower covenants.
- **Employment** – assessing any specific issues relating to COVID-19 (such as remote working).
- **Governance** – analysing any special governance arrangements put in place to overcome current obstacles.

Pricing issues and deal certainty in uncertain times

In the COVID-19 era, it is proving more challenging than ever to strike the right deals at the right price. Both buyers and sellers will be in search of strategies which can help them to bridge the expected valuation gaps and achieve deal certainty.

- **Pricing structures** – parties are expected to consider moving away from a locked-box pricing structure (where the sale price is based on historic accounts signed off on a date prior to completion) and instead favour completion accounts structures (where the valuation is determined only after completion). This is because buyers are unlikely to be willing to take the risk of any business deterioration between the locked-box date and completion.
- **Deferred consideration** – earn-out structures have proved to be a useful tool for bridging valuation gaps in economic downturns, including 2008-09. Earn-outs can be complex and potentially subject to litigation, and COVID-19 will add another layer of complexity. In particular, buyers and sellers will need to agree contractual protections for the operation of the business post-completion. Given the dynamics of a particular deal, buyers may also want to pursue other deferred consideration strategies, such as seller financing, or less typical earn-out concepts, such as an early buy-out option.
- **Other potential valuation trends** – we can expect to see: greater use of the downside protections (such as preferred equity) typically incorporated in venture capital transactions; investments structured as a hybrid debt/equity instrument to offer downside protection with the prospect of equity upside in the future; and convertible bridge loans with an agreed conversion discount triggered by subsequent equity investment.
- **Material adverse changes (MACs)** – it is expected that parties may have to negotiate as to whether any material deteriorations of the business between signing and closing due to COVID-19 should be introduced as a MAC in the transaction documentation, thus entitling the buyer to terminate the deal before closing. The outcome will depend on the mutual bargaining power of the parties.

Key takeaways

Given the current high levels of uncertainty, innovative and commercial solutions may be needed to deploy capital and execute deals at attractive valuations. Lawyers can help to develop these.

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COVID-19: Be guided by data and principles

The economic outlook has changed completely since January. If you can't recall a reversal of similar magnitude, that's because there hasn't been one in living memory. Here, Fahad Kamal, Chief Market Strategist of Kleinwort Hambros, assesses the economic impact of the coronavirus so far and the implications for investors.

The figures from the first quarter are hard to believe: one million confirmed cases of the new Coronavirus worldwide, with 53,000 deaths by early April; severe recessions, with contractions of 10% to 20% now expected for the major global economies over the first two quarters; unemployment rates in advanced economies swinging within weeks from record lows to double-digit territory; the fastest bear market in history, as global equity markets plunged 20% to 30% from their mid-February peaks; a 60% collapse in the price of crude oil; and high-yield corporate bonds generating returns of -13%.

In January, the consensus view was that the coronavirus would be contained, as SARS and Ebola had been. Although the pandemic took us by surprise, we constantly discuss tail risks: events which have a low probability but a potentially high impact and can lead to sudden declines in the prices of riskier assets, such as equities. As a result, we retained significant exposure to government bonds, gold and low-volatility alternative investments in clients' multi-asset strategies.

Now what we all want to know is how long it will take for the coronavirus to be brought under control. Then, how long will it take economies to recover? And have equities and other risk assets reached the bottom of their declines?

The answers can only be known with hindsight. So we always rely on the discipline of our investment process to assess the balance of probabilities. Currently, our process is signalling caution for the following reasons:

- **Economic regime:** We are entering a global economic recession, and recessions are not good for riskier assets.
- **Valuations:** it's hard to assess global equity valuations, given rapidly moving share prices and uncertainty about earnings. But they don't look unambiguously cheap, and there is room for further falls.
- **Momentum:** The momentum signal is clear, with global equity markets across all regions trading well below their respective ten-month moving averages.
- **Sentiment:** Arguably, this might suggest increasing exposure to riskier assets. However, sentiment may continue to deteriorate, given the enormous uncertainty surrounding the outlook.

Our views are also guided by the following considerations:

- **Drawdowns:** By early April, global equities' maximum decline from their recent peak was 25%, around the average drawdown over history. However, the drawdowns were about 50% in 2000 and 2008 and over 80% in the Great Depression. So equity markets could have much further to fall.
- **Volatility:** Markets are very volatile at present. From 2015 to the end of 2019, the MSCI AC World Index moved by more than 3% in any direction on just two days; since 27th February 2020, it has done so 13 times.

We aim to get the big decisions right (the broad weight of riskier assets versus safer assets in portfolios); to take risk only when it is likely to be well rewarded (i.e., valuations for risk assets are attractive); and to avoid large losses. We have therefore reduced risk across our multi-asset strategies. Perhaps the worst is already over. But we think it wiser not to be over-exposed in case the worst is yet to come.

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